

Faculty of Law
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PG Dip in Tax Law

Research paper

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2014

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Was the Supreme Court of Appeal judgment correct in the *Founders Hill* case?

1.0. Introduction

A dispute between the taxpayer and the Commissioner regarding the tax liability of a taxpayer in a given set of circumstances is often taken to court where a decision will be made to resolve the dispute between the two parties. A Tax Court may be approached first to try resolving the matter. However, if any of the parties is not satisfied with the decision taken by the Tax Court, an appeal may eventually be made to the Supreme Court of Appeal.

This was the situation in the *Commissioner for the South African Revenue Service (CSARS) v Founders Hill*¹ case. A dispute arose between the Commissioner and Founders Hill (Pty) Ltd ('Founders Hill') regarding the disposal of land² acquired by Founders Hill as a realisation company. The Commissioner had initially not taxed Founders Hill on the proceeds of the sale of the land. However, later the Commissioner revised the assessment and taxed Founders Hill on the proceeds of the sale of the land, with the view that these proceeds were of revenue nature. Founders Hill appealed to the Tax Court; expressing its position that it had merely realised a capital asset, and thus it was not liable for tax (this was before capital gains tax was introduced). The Tax Court held in favour of Founders Hill. The Commissioner was not satisfied with the decision, and took the matter on appeal to the Supreme Court of Appeal. At the Supreme Court of Appeal, the Court held in favour of the Commissioner; that the proceeds were in fact revenue nature.

It is unfortunate that the decisions of the Tax Court are not binding to other courts, because in other cases the judgments made in Tax Courts are more convincing than those made in the Supreme Court of Appeal. However, decisions held in the Supreme Court of Appeal are binding on lower courts³. This is in accordance with the *stare decisis* principle. The *stare decisis* rule originates from English law and was incorporated into South Africa law. It is a Latin noun which literally means to 'stand

¹ *CSARS v Founders Hill (Pty) Ltd 2011 (5) SA 112 (SCA), 73 SATC 183, 2011 Taxpayer 86*

² The use of the word land / property or erven will be used interchangeably throughout this dissertation

³ ITC 1806 (2005) 68 SATC 117 (G) at 139

by things decided⁴. Therefore, this means that Judges dealing with cases similar to the *Founders Hill* case in the future will be bound by the tax principles found in the judgment of the Supreme Court of Appeal. For this reason, principles found in such cases are of paramount importance because the Income Tax Act No. 58 of 1962 (the 'Act') does not distinguish between receipts or accruals of a capital or revenue nature, and it does not define realisation companies. The Act only defines gross income and states that proceeds of capital in nature are not to be included in gross income. Hence, courts dealing with such matters would have to rely on principles found in case laws.

This dissertation focuses on the *Founders Hill* case, and more on the judgment made by Lewis JA at the Supreme Court of Appeal. We will look at the arguments that have been made in favour and against Lewis JA's judgment, and then I shall comment on these arguments. Reference to tax law cases relating to principles on capital vs. revenue receipts and realisation companies will be made. I will also conclude with the position I take together with my reasons. To begin with, I will have a brief look at the facts pertaining to the background of *Founders Hill* and its disposal of the property it had acquired from its parent company.

1.1. Background to Founders Hill⁵

AECI Ltd owned and occupied land which it held as a fixed capital asset for many years, meaning AECI Ltd was not trading in land. AECI Ltd subsequently formed Founders Hill as a realisation company. Founders Hill was wholly-owned by AECI Ltd, and was formed for the sole purpose of realising land held by AECI Ltd as a fixed capital asset. Upon the sale of the land by Founders Hill, the proceeds were to be awarded back to AECI.

AECI Ltd was formed in 1924 following a merger between the British South Africa Explosives Company and Cape Explosive Works. AECI Ltd acquired vast tracts of land in the process, including land at Modderfontein in Johannesburg. The area of the land was some 4 100 in hectares in extent.

⁴ Pretorius, Lizl, *A critical analysis of recent Supreme Court of Appeal judgments that have deviated from the stare decisis principle*, International Institute for Tax & Finance in association with the Thomas Jefferson School of Law, 2012

⁵ Facts from the *CSARS v Founders Hill (Pty) Ltd 2011 (5) SA 112 (SCA), 73 SATC 183, 2011 Taxpayer 86* case. These facts are summarized in my words, however some phrases and paragraph are exactly from the case.

By the mid-eighties the legal and technological environment had changed significantly. Authority had been transferred from central to local government. Town planning responsibilities had been passed on to AECI. The reason for this was that the manufacture of explosives had changed; the buffer around the factory that had been built on the land was no longer required to be as wide-ranging as it had once been. In the Johannesburg area, the need for housing and greater urban density had become pressing. Accordingly, the Johannesburg City Council and AECI engaged to work together in planning a process to address these changes. A number of professionals were asked to produce a strategic plan to deal with future development of the land, including proposals as to different land use.

In a memorandum to the AECI board dated 2 March 1989, Mr J C von Solms recommended that the strategic plan that had been developed be accepted: that AECI take the decision to sell or develop the land, and commence the process step by step. The proposal was accepted. One of the first steps was the formation of Founders Hill - a wholly owned subsidiary of AECI. It was incorporated at the beginning of 1993 and its main business was: 'to acquire from AECI Ltd certain properties situate at Modderfontein, Johannesburg which were held by AECI Ltd as a capital asset and which have become surplus to its needs, *for the sole purpose of realising same to best advantage* and within a period of year of completion of such realisation to be voluntarily wound up'.

Founders Hill was formed as a realization company for the purpose of facilitating the realization of property. Founders Hill did no more than act as the vehicle used to realise the property for the interests of its shareholder, namely AECI. Surpluses made from the disposal of the property would supposedly not be taxable as trading profits, since such surpluses would be capital receipts. In other words, AECI's view was that the sale of the land would be the realising of a capital asset and therefore any gain realised would be of a capital nature. Founders Hill followed the same line of thinking and maintained that it done no more than realise a capital asset advantageously⁶.

⁶ Pretorius, loc.cit

2.0. Analysis of the judgment made in the Supreme Court of Appeal for the *Founders Hill* case⁷

Many taxpayers believe that the interposition of a realisation company to dispose of a fixed capital asset results in the proceeds being capital in nature, thus not part of gross income as per gross income definition of the Act. Croome mentions that

‘the leading commentators on tax in South Africa have always believed that where a company acquires an asset with the intention of reselling it, the proceeds for that asset constitutes revenue proceeds liable to tax. The only exception to this view was relating to realization companies. Their argument was that these companies are not created in order to dispose of assets as part and parcel of a scheme of profit making, but rather to execute the sale on behalf of its parent company, which had held the asset as a capital asset. Therefore, the general view was taken that profits realized from sales of property by a realization company are capital in nature and therefore not taxable.’⁸

Also, Pretorius mentions that a common practice followed by taxpayers when wanting to dispose of property was to incorporate a realisation company with the mandate of realising the property/(ies) to its best advantage. The realisation company would then distribute the profits realised to its shareholders and thereafter to cease to exist (liquidate, deregister or wind-up) as it served its purpose and it had no intention to exist long-term or to carry on a trade.⁹ No other reason but the disposal of the property on behalf of the original owner was required in order for a company to be set up as a realisation company. Furthermore, it was accepted that the property would retain its nature as a capital asset where the original owner held the property with a capital intention. The transfer of the property from the original owner to the realisation company would not alter the original nature of the property nor the intention with which it was acquired by the original owner.¹⁰ Hence, the

⁷ *CSARS v Founders Hill (Pty) Ltd 2011 (5) SA 112 (SCA), 73 SATC 183, 2011 Taxpayer 86 case*

⁸ Croome, Beric, *Realization companies and nature of proceeds received for tax purposes*, EN Safrica, 2013, <http://www.lexology.com/library/detail.aspx?g=0a2203ed-1b25-42b6-8cb7-36b4359a09b1>, viewed 1 November, 2013

⁹ Pretorius, loc.cit

¹⁰ Pretorius, ibid

controversy about the recent judgment made by Lewis JA in the Supreme Court of Appeal case, *Founders Hill*.

The distinction between revenue and capital proceeds arising from the disposal of an asset is of utmost importance in this case. Unfortunately, the 'Act' only excludes proceeds of a capital nature from gross income but does not define what constitutes 'capital in nature'. However, there are some special inclusions of capital receipts in gross income in terms of the Act. Nevertheless, proceeds on sale of land are not part of the special inclusion provisions. For this reason, tax law principles from previous cases dealing with the distinction of capital and revenue proceeds have been applied. One of the most longstanding tax law principles that have been established is the intention of the taxpayer in acquiring the asset, and serves as a starting point. This principle comes from an old case, *CIR v Stott* case¹¹.

In the *CIR v Stott* case, the taxpayer had acquired land with the primary intention of building a seaside residence thereon. Hence, this land was a capital asset, and at that point the taxpayer was not a dealer in land. Subsequently, the taxpayer subdivided the property and sold off half of his land at a profit. The Commissioner included the proceeds of the sale on the basis that the taxpayer had changed his original intention in acquiring the land and had embarked on a scheme of profit-making, and this was upheld by the Special Court. However, the National Provincial Division reversed the decision of the Special Court, holding that the proceeds were accruals of a capital nature.

On appeal by the Commissioner to the Appellate Division, Judge Wessels JA held that the intention with which the asset was acquired is an important factor to determine whether the proceeds derived from the sale of the asset are of a capital or revenue nature. Therefore, the taxpayer acquired the land as capital asset and there was no doubt about that. The issue was whether there had been a change in intention seeing that the taxpayer was involved in some acts which could indicate that he had embarked on a scheme of profit-making. The Judge went as far as saying

¹¹*CIR v Stott 1928 AD 252, 3 SATC 253*

‘every person who invests his surplus in land or stock or any asset is entitled to realise such asset to the best advantage and accommodate the asset to the exigencies of the market in which he is selling; and the fact he does so cannot alter what is an investment of capital into a trade or business for earning profits.’¹²

The taxpayer had not changed his initial intention and hence, the appeal was dismissed.

One should also take note of the other tax law principle that a taxpayer is entitled to realise the asset to the best advantage, over and above the principle of ‘the initial intention of the taxpayer’; in this case above. In other words, ‘the initial intention’ principle is not a decisive factor as to whether proceeds at the time of sale are revenue or capital. Therefore, proceeds may be revenue nature despite the asset being acquired as a capital asset.

This brings us to next tax law principle of ‘crossing the Rubicon’, which was established in *Natal Estates Ltd v SIR* case¹³. In this case, the taxpayer had acquired the land as a fixed capital asset. However, subsequently the taxpayer was regarded to have changed its initial intention. The reason being, the activities conducted by the taxpayer before disposing the land was not merely realising its capital to best advantage. However, it was more business-like, leading to the taxpayer crossing the Rubicon. Therefore, it was now carrying on a business of selling land for profit, using land as its stock-in-trade. As a result, the proceeds for the sale of land were of a revenue nature in the hands of the taxpayer.

Now the issue is that there is no set rule to differentiate between realising a capital asset to best advantage and actually crossing the Rubicon. For this reason, in determining whether the taxpayer has merely realised the asset to best advantage or has crossed the Rubicon is subjective and depends on the facts of each case¹⁴. This is where one should apply their judgment to reach a conclusion and have convincing reasons to substantiate their view point.

¹² *CIR v Stott* 1928 AD 252, 3 SATC 253

¹³ *Natal Estates Ltd v SIR* 1975 (4) SA 177 (A), 37 SATC 193, 1975 Taxpayer 161

¹⁴ Hannington, Andrew, *Does the Founders Hill judgement really overturn established tax principles?* Moneyweb’s Tax breaks, 2011, p 6

Having identified some long-standing tax law principles above, we can revert to the *Founders Hill* case. In this case, it was common cause that the surplus of land in question was acquired as a fixed capital. The Commissioner challenged Founders Hill, however, that it had subsequently ‘crossed the Rubicon’ and became a trader in land by reason of the nature and extent of its activities in developing and selling the erven. To support its proposition, the Commission relied on the decision in *Natal Estates Ltd v SIR* case¹⁵. On the other hand, Founders Hill argued that it had not traded in land but merely realised the capital asset to best advantage. Founders Hill cited in support of this proposition the case of *CIR v Stott*, where Sir John Wessels said:

‘every person who invests his surplus in land or stock or any asset is entitled to realise such asset to the best advantage and accommodate the asset to the exigencies of the market in which he is selling; and the fact he does so cannot alter what is an investment of capital into a trade or business for earning profits’¹⁶.

Therefore, argued Founders Hill, the proceeds constituted a receipt of a capital nature. Accordingly, no tax was payable on the basis that the proceeds were realised prior to the introduction of capital gains tax.

The dispute between the two parties was taken to the Tax Court, which found that Founders Hill had not commenced any trade. Accordingly, it held that the proceeds of the sale of land were capital in nature. The Commissioner then appealed directly to the Supreme Court of Appeal. Again, both the Commissioner and Founders Hill were satisfied that the land had been acquired by Founders Hill as a fixed capital asset and that the only issue was whether or not Founders Hill had crossed the Rubicon and embarked upon the trade of selling land for profit.

It is crucial to look closely to facts of the case, particularly the activities that Founders Hill engaged in prior to selling the property, in order to determine whether or not Founders Hill had changed its initial intention of holding the land as a fixed capital asset. In fact, Founders Hill did not undertake any development or selling of the land itself; Heartland Properties (Pty) Ltd (Heartland) acted on its behalf. Heartland, a

¹⁵ *Natal Estates Ltd v SIR* 1975 (4) SA 177 (A), 37 SATC 193, 1975 Taxpayer 161

¹⁶ *CIR v Stott* 1928 AD 252, 3 SATC 253

marketing company, was a wholly owned subsidiary of AECl too, and was introduced into property selling activities of AECl in 1998. The new managing director of AECl was of the view that the surplus of properties owned by AECl should be sold more aggressively. He believed that if they were marketed more professionally and extensively they would achieve higher prices.

The question now is whether or not these activities performed on behalf of Founders Hill by Heartland were merely performed in a manner that would realise the property at best advantage. I believe very strongly that a dealer in land does market his or her properties aggressively to make sure the sale of the properties does take place. In light of this, the activities performed by Heartland on behalf of Founders Hill had the potential of competing with the business of companies trading in land since Heartland was marketing the land professionally and extensively. For this reason, Heartland activities were business-like and it appears that the director was eager about making higher profits. So I feel Founders Hill crossed the Rubicon by means of activities performed by Heartland on its behalf, and had therefore, embarked on a scheme of profit-making. Therefore, with great respect of the decision made in the Tax Court, that Founders Hill realised the land to best advantage; my view is that the Tax Court should have reached a different decision. In so doing, the matter should not have gone to the Supreme Court of Appeal.

In the Supreme Court of Appeal, Judge Lewis JA mentioned that the issue of whether or not Founders Hill had changed its initial intention by crossing the Rubicon made the assumption without evidence that the property had in fact been a fixed capital asset in the hands of Founders Hill in the first place. Therefore, according to Judge Lewis JA the issue was whether or not Founders Hill had acquired the property as a fixed capital asset or a revenue asset held for trading. As a result, the lines of arguments of Judge JA were different from those of the Commissioner. In other words, the Judge went further than the Commissioner originally argued by indicating that the property was never acquired as a fixed capital asset and that it was, therefore, unnecessary to determine any event whether there may have been a change in intention.¹⁷

¹⁷ Croome, Beric, *SARS argues company crossed the tax Rubicon*, Business Day, p 12

Judge Lewis concluded that Founders Hill held the land as trading stock. Broomberg mentions that

‘According to the Supreme Court of Appeal, the rule was simple; if a person acquires an asset intending to resell it, that person is trading, and therefore, the asset cannot be a fixed capital asset, and the net proceeds of the disposal of such asset are taxable as income. It follows, so reasons Judge Lewis JA, that since a realisation company acquires the asset in question with the intention of reselling it, the realisation company does not acquire the asset as a fixed capital asset, and the net proceeds of the disposal of such asset are therefore revenue in nature.’¹⁸

Hence, Founders Hill held the land as trading stock since it had acquired the erven with an expressed intention of selling it – carrying on the business of selling land.

Kretzmann and Collings reckon that the rule made by Lewis JA has an impact which can be illustrated by the following example: ‘If a taxpayer purchases property as an investment, but intends to realise the property (at a later stage) at a profit, such realisation will be considered to be of a revenue nature due to the fact that the taxpayer had acquired the property with the intention to realise it for a profit. Accordingly, such a property will be deemed to be trading stock and, as a result, any profit derived will be included in the taxpayer's taxable income.’¹⁹ Nevertheless, Kretzmann and Collings are also of the opinion that

‘from the judgment it is not clear whether it was the Court's intention that the tests applied in this case must be applied to all transactions or whether it only applies to realisation companies; however, until this is clarified, taxpayers are bound by the precedent set down in the judgment and need to be mindful of the potential impact thereof when structuring their affairs.’²⁰

¹⁸ Broomberg, Eddie, *The Taxpayer* Volume 60 No 10 & 11, 2011, a paper recently given at seminars presented under the auspices of the SA Fiscal Association p 188-190

¹⁹ Kretzmann, Ansu, and Collings, Ruweida, *South Africa: Unintended Consequences Of The Principles Laid Down In The Founders Hill Case*, 2011

²⁰ Kretzmann, Ansu and Collings, Ruweida, loc.cit

According to Pretorius²¹, the implication of the Court's decision is that the standpoint taken by Lewis JA has caused dismay amongst the business community for questioning the purpose of establishing a realisation company in the first place, since it is not the intention of a realization company to carry on a trade. Having to prove or provide a commercial reason for incorporating a realization company to dispose of assets would restrain the business community from disposing of assets in a method that they deem to make the most economical at the time.

However, one can still challenge the approach taken or the simple rule raised by Judge Lewis JA, by questioning that whether the mere intention of acquiring an asset with an expressed intention of reselling it means that a company is trading in the asset in question, especially in a case of a realisation company. Well established principles of what constitutes trading could be of great help here to evaluate the approach taken in the Supreme Court of Appeal. In the *CIR v Pick 'n Pay Employee Share Purchase Trust* case²², Judge Smalberger JA mentioned that a test to distinguish between capital and revenue receipts or accruals arising from the sale of an asset is the inquiry whether the taxpayer was engaged in a 'scheme of profit-making' i.e. business was conducted with a profit-making purpose. The court concluded that where no trade is conducted there cannot be floating capital, no trade means no trading stock.

Now, applying these principles to the *Founders Hill* case, one could conclude that Founders Hill never held its property as trading stock since it was not formed as a business to operate to make profits by selling land but was formed as a realisation company with the intention of realising its property at best advantage. Moreover, it is essential to look at the intention of the holding company forming the realisation company because the realisation company is acting on behalf of its holding company, which means if the asset was a capital asset in the hands of the holding company, it automatically becomes a capital asset upon acquisition of the property by the realisation company. Broomberg supports this by saying that

'In the case of a realisation company, the intention and the purpose of the subsidiary in acquiring the asset in question will be to realise it on behalf

²¹ Pretorius, Lizl, loc.cit

²² *CIR v Pick 'n Pay Employee Share Purchase Trust* 1992 (4) SA 39 (A) at 46A-52B

of the parent company, and to account to the parent the net proceeds;
therefore, it has no profit motive on its own account.²³

Further on, Broomberg²⁴ argues that the proposition made by Judge Lewis JA overlooks the fact that there is a rider to the golden rule, which is to the effect that there cannot be a trade without an intention to trade. He also adds that this fundamental principle applies not only to an isolated transaction, but equally to a continuous series of transactions which, objectively viewed, might be perceived as amounting to the carrying on of a business. This was the decisive issue in the *CIR v Pick 'n Pay Employee Share Purchase Trust* case. In short, Broomberg reckons that the Court in the *Founders Hill* case seems to have ignored the fact the *ratio decidendi* in the *Pick 'n Pay* case was to the effect that it is not enough that a taxpayer acquires an asset with an intention to resell it to make the asset a floating capital; the asset must have been resold as an operation of business in a scheme of profit making: the purpose of the transaction must have been to trade for profit.

Over and above the principles found in the *Pick 'n Pay* case, Broomberg continues and refers to principles found in the *ITC 1283* case; where a former Angolan resident, in fleeing the turmoil in that country, converted his Angolan fixed assets into coffee beans, transported them by truck over the border into South West Africa, and there sold them, and the trucks, at the profit. It was held that he was merely realising his Angolan fixed capital assets, and was not trading for profit.²⁵

According to Broomberg²⁶, it is, of course, on the basis of this principle, viz that if there is no intention to trade for profit, there is no trade, that the courts in the Republic and abroad have held that realisation companies are not taxable on the proceeds of disposal of their assets. To sum up, although the assets are acquired by the realisation company with the intention of reselling them, the purpose is not to trade for profit: the sole purpose is to realise the assets on behalf of its shareholders, and to account to the shareholders for the net proceeds. It follows that the assets are not acquired as trading stock and the net proceeds of the realisation of a capital nature. That is the rule; and it is founded on basic principles. With the greatest

²³ Broomberg, Eddie, loc.cit

²⁴ Broomberg, Eddie, ibid

²⁶ Broomberg, Eddie, loc.cit

respect, the Court in the *Founders Hill* case erred in ruling that the general rule is that a realisation company acquires its assets as trading stock. The general rule has always been that a realisation company acquires its assets as fixed capital.

Moreover, Troskie²⁷ mentions that it has been a common long-standing principle amongst taxpayers that if a company is formed as a so-called realisation company to sell off land or property on behalf of its parent company, the net proceeds will be capital in nature and be subject to capital gains tax, if there is any. Troskie also supports his comment by saying that

‘some academic writers have also created an impression that the use of a realisation company should secure the income from the sale of the property as capital in nature. Legal and tax advisors have followed suit, advising clients to set up realisation companies when they need to sell off land or property owned by them, to secure net proceeds as capital in nature.’²⁸

However, the Court in the *Founders Hill* case said that the formation of a realisation company was as good as ensuring the net proceeds upon sale of the property would be revenue in nature. Thus, taxed at a full corporate tax rate. Also, what the court said is that the use of a realisation company will only ensure that the proceeds of a sale are of a capital nature in limited circumstances. In all other cases, the use of a realisation company is likely to give rise to income of a revenue nature, and therefore would be fully taxable.

Surprisingly, the Court relied mainly on the judgment of Holmes JA in *Berea West Estates (Pty) Ltd v SIR* case²⁹, a case where a realisation company’s proceeds were capital in nature. It is also strange because Founders Hill relied heavily on the same judgment made by Holmes JA to defend against the contention made by the Court. The Court contended that the general rule is that the proceeds of a realisation company are revenue in nature and therefore taxed at full corporate tax rate. Even worse, Judge Lewis JA asserts that, in *Berea West Estates* case, Holmes JA held that there is a general rule that the assets of a realisation company are acquired as

²⁷ Troskie, Johan, *Far-reaching judgement may cause upsets in property sales*, 2011. Moneyweb’s TAX BREAKS p 5.

²⁸ Troskie, Johan, loc.cit

²⁹ *Berea West Estate (Pty) Ltd v SIR 1976 (2) SA 614 (A), 38 SATC 43*

trading stock, and will only be recognized as being of a capital nature in exceptional cases, *viz* where the company was formed for the purpose of facilitating the realisation of an asset ‘which could not otherwise be dealt with satisfactory’ by the original owner. Founders Hill must have been displeased to hear this statement from Lewis JA and it would not agree that Holmes JA had made such general rule³⁰.

In his article, Hannington³¹ supports the conclusion made by the Court in *Founders Hill* case. He mentions that the Court was correct in saying that

‘although *Berea West* and other case law have established that there are special rules applicable to realisations by a realisation company, merely calling an entity a “realisation company” does not constitute a magical act that inevitably makes the profits derived from the sale of assets of a capital nature; and a realisation company will stand in the shoes of the entity that has sold assets to it, and hold them in turn, as capital assets, only in special circumstances; however, special cases do not create general rules’.

Hannington³² continues further to say, in support of the Court, that

‘such special circumstances did not exist in the case of *Founders Hill*; in contradistinction to *Berea West* and the other cases (referred to above), although Founders Hill was formed with the avowed purpose of realising land (formerly owned, as a capital asset, by its holding company, AECl Ltd) to best advantage, it was a wholly owned subsidiary of AECl; it was not established to consolidate the interests of a number of parties in order to facilitate a unified realisation to best advantage; and AECl could have realised the asset itself without the intervention of the realisation company; In fact, Counsel for Founders Hill could not explain why the realisation company was necessary other than that AECl had taken legal advice to this end’.

Moreover, he argues that

³⁰ Broomberg, Eddie, loc.cit

³¹ Hannington, Andrew, loc.cit, p 7

³² Hannington, Andrews, loc.cit, p 8

'in Berea West and the latter cases for the formation of the realisation entity was justified with real reasons (in addition to the purpose of realising the assets); First, a number of persons (not only one) transferred the asset to the interposed entity; and second, the interposition of a company or trust was necessary for the realisation of the asset, otherwise the realisation would have been difficult if not impossible'.

Sonnenbergs³³ also adds that

'the Court in *Founders Hill* case considered the relevant cases and found that only companies or trusts with convincing reasons why the owners of the assets had found it necessary to transfer the assets into a company (or sometimes a trust) won the argument. Therefore, it is the presence or otherwise of one or more convincing reasons that characterises a realisation company. It is not sufficient merely to argue that, had the owner sold the asset without alternative to using a realisation company, the proceeds would have been capital in nature. In the best known examples where entities were found to be merely disposing of their assets to best advantage, there was a real justification for the formation of the company. On the other hand, in cases where the taxpayer had failed to convince the court that it was a realisation company or that, if it was, the proceeds were nevertheless found to be of a revenue nature, it was not credible to use a company as a disposal vehicle.'

To my understanding, the special cases that the Court in the *Founders Hill* case referred to, include cases where more than one company transferred assets to the realisation company and where the interposition of a company was necessary to realise the asset. One can challenge the need for these special cases. Firstly, a question like this can be raised: what is the significance of having more than one person transferring the asset to the interposed company, in changing the nature of the asset (capital or revenue nature)?

Secondly, if an asset was held as a fixed capital asset by a parent company in the first place and suppose, it was neither impossible nor difficult to realise the asset

³³ Sonnenbergs, Nathan, *SCA crystallizes the tax status of realisation companies*, Norton Rose South Africa, ISSUE 146, 2011

itself. In a situation like this, a reasonable person would not go through the burden of forming a realisation company and have its proceeds being taxed at full corporate tax rate. While it would have disposed the asset without forming a realisation company and have the proceeds not taxed (old legislation), however in terms of the legislation today, proceeds would not escape taxation altogether as was the case in the past. For this fact, it appears that there is no significant link between reasons of forming a realisation company and the nature of the asset acquired by the realisation company. Also, the proposition made by Lewis JA and the argument made by Hannington in favour of Lewis merely suggests that AECI Ltd was illogical in its conduct of forming Founders Hill since it went through the burden of forming Founders Hill whilst it could have developed and sold the land itself as this would result in capital proceeds. For this reason, one would still see no real significance of the proposition made by the Court or the argument made by Hannington, in his article.

Since both the Court and Founders Hill relied mainly on the judgment made by Holmes JA in the *Berea West Estate* case, Broomberg believes that it is necessary to examine that judgment quite closely, and to have regard to the actual words used by Holmes JA. The actual words that Holmes JA used in articulating the realisation company rule in *Berea West Estate* case are as follows:

‘Suppose for example, A and B and C own a tract of land, not having acquired it with the a view to sale, and they wish to realise this fixed capital asset; and they promote a company and become the exclusive shareholders; and they transfer the land to the company for the purpose of realising it the asset; and , when it is has been sold, the company is to be wound up and its assets distributed among the shareholders. The company would be regarded as a realisation company, and not a company trading for profits, and the surplus would regarded as capital in nature; unless, of course, the company conducted itself as a business trading for profits, using the land as trading stock.’³⁴

Broomberg further argues that

³⁴ Bloomberg, Eddie, loc.cit, p 192

‘it is clear that Holmes JA, in the *Berea West Estate* case, did not consider that it was a requirement for the recognition of the proceeds of disposal by a realisation company as being of a capital nature, that it would have to have compelling reasons for the interposition of the company and that the interposition of a realisation company was therefore necessary. However, Holmes JA’s decision that proceeds of disposal of a capital asset by a realisation company were of a capital nature was justified based identifying several factors. These included the objects of the company as stated in its Memorandum of Association (now known as Memorandum of Incorporation), the provision in the Sale and Purchase Agreement that when the whole property had been realised the company was to be wound up, and the remaining available funds distributed among shareholders, the fact that the company allotted an aggregate of 720 vendor shares to the beneficiaries, enabling the company to make a precise *aliquot* distribution to them, and the fact that there were no other shareholders. In a word, there is nothing in the *Berea West Estate* judgment that provides support for the argument that compelling reasons are required which the Lewis JA relies on. It contradicts that position’³⁵

Moreover, Croome says that ‘*Berea West* case is similar to the *Founders Hill* case, in a sense that in *Berea West* the company was created for the purpose of realizing assets for the benefit of various beneficiaries and not for a single shareholder as was the case in *Founders Hill*.’³⁶ Therefore, it is odd that the Court treated the *Founders Hill* case differently from the *Berea West Estate* case.

With the greatest respect to the judges in the *Founders Hill* case, Broomberg acknowledges that ‘the counsel for AECI, the Commissioner’s counsel and the Tax Court *a quo* approached the matter correctly. *Founders Hill* had acquired the land as a fixed capital asset and not as trading stock. The only main issue was whether *Founders Hill* had subsequently changed its initial intention to sell land as trading stock. In treating the net proceeds of the disposal of assets by a realisation company as being of capital nature, the Courts in *Berea West Estate*, *Malone Trust et al* were simply applying the basic principle, the golden rule that holds that if there is no

³⁵ Bloomberg, Eddie, loc.cit

³⁶ Bloomberg, Eddie, loc.cit, p 193

trading for profit there can never be trading stock. This had nothing to do with the supposed exception to a supposed general rule, as the Court in *Founders Hill* case would have it.³⁷ For these reasons, with great respect to the *Founders Hill* Court, it appears that the *Founders Hill* Court misinterpreted the basic principle found in the *Berea West Estate* case, and this has the chance of having a cascading effect on any future cases regarding realisation companies on capital vs revenue nature issues.

Even more, Broomberg examines the inference that the *Founders Hill* Court seeks to draw,

‘that where only one person was the owner of the asset in question, or where there was no reason why the owner could not itself have realised the asset, the rule is that the is taxable on the proceeds of the realisation company; however, where the owner of the asset could not itself have realised the asset, there is an exception to the rule, and thus the Commissioner need not tax the profit’³⁸

Upon examination of this conclusion, ‘Broomberg feels it is difficult to follow this argument. In the first place, if there is such a general rule that a company is taxable, there are no legal principles that allows the Commissioner to make exceptions for a taxpayer not to be taxed. The Commissioner has no power to waive any liability for tax: *Namex (Pty) Ltd vs CIR* case.’³⁹ Therefore, it does not make sense how this supposed exception could be applied in the *Berea West Estate* case given that the Commissioner has no legal power to waive tax liability in any way, be it by way of an exception.

Broomberg continues to support his argument by say

‘Secondly, even if the Commissioner was entitled to make exceptions, the basis of the exception perceived by the Court in *Founders Hill* does not make sense. If the original owner could have realised the fixed capital asset itself, it would be illogical to seek to tax the realisation company,

³⁷ Croome, Beric, loc.cit

³⁸ Bloomberg, Eddie, loc.cit, p 194

³⁹ Bloomberg, Eddie, ibid

since there has been no change in the beneficial interest in the asset, and no material difference in the position of the two companies⁴⁰.

This essentially supports the criticism made earlier about the argument made by Hannington⁴¹ in favour of Lewis JA. Also, Pretorius mentions that

‘By way of contrast, if there is some reason why the original owner could not itself realise the asset, there is at least vestige of an argument for refusing to recognise the interposed company as being the mere *alter ego* of the original owner since it is doing something the owner could not do, and therefore, as a taxpayer in its own right, it may be suggested that it should be taxed.’⁴²

However, the judgment made by Lewis JA suggests otherwise.

Davis⁴³ also responded to the *Founders Hill*. Davis said that Lewis JA misread the *Berea West* case thereby creating uncertainty with respect to the use of a realisation company to realise assets to the best of a taxpayer’s advantage. Clegg⁴⁴ however responded to Davis’ article by indicating that he agreed with Lewis JA that an external influence or virtually insuperable problem that requires the property concerned to be taken out of the hands of its original owner in order for the realisation to take place is sound, otherwise there would not be a need for a separate entity to realise the asset on their behalf. Clegg⁴⁵ concluded that since no apparent reason existed to create a realization company that Lewis JA was correct to say that the *Berea West* case did not apply to the *Founders Hill* case.

In his research paper, Pretorius⁴⁶ contends that Lewis JA overlooked the basic requirements necessary for a company to be taxed, i.e. the taxpayer must be carrying on a trade with the intention of making a profit. Though Lewis JA made use

⁴⁰ Bloomberg, Eddie, *ibid*

⁴¹ Hannington, Andrews, *loc.cit*, p 6

⁴² Pretorius, Lizl, *loc.cit*

⁴³ Pretorius, Lizl, *ibid*

⁴⁴ Pretorius, Lizl, *ibid*

⁴⁵ Pretorius, Lizl, *ibid*

⁴⁶ Pretorius, Lizl, *ibid*

of court cases as well as published works of authors pertaining to tax matters in order to conclude that a realisation company could only be used if more than one person transferred the assets to the interposed entity and that without doing so it would be difficult, if not impossible to realise the assets. The purpose of a realisation company is merely to dispose of the assets acquired by it, and thereafter distributing the profits to the shareholders of the company which was the original owner of the asset. This was Founders Hill's intention all along as a realisation company. A realisation company was used to obtain the same effect as that in the *Berea West* case, in that the profits upon the sale of the property would be distributed to the original shareholders (i.e. original owners of the property).

Pretorius⁴⁷ continues to express his concern that counsel for Founders Hill was unable to argue that the trade requirement would not be met and therefore the sale of the land would be capital in nature when questioned by Lewis JA. One would imagine that counsel and management of Founders Hill would have asked why forming a realisation company would be required and how it would affect the tax position of AECI as well as Founders Hill. He agrees with the view expressed by Broomberg⁴⁸ that it would be interesting to see if this case would be used in future cases heard dealing with realisation companies and if it would have any authority at all since the trading requirement needs to be met first prior to questioning whether or not the asset is capital in nature or forms part of trading stock. Therefore, the basis of concluding that the proceeds would be revenue in nature should have been based on the Commissioner's argument that Founders Hill 'crossed the Rubicon' which brought the sale of the erven into the revenue net.

Furthermore, upon analysis of the judgment in the *Founders Hill* case, Broomberg⁴⁹ finds it ironic that the Court based its decision that Founders Hill was liable to tax on the ground that the company's intention to buy and sell the land was indeed conclusive; yet in paragraph [25] of her judgment, Lewis JA expresses the view that

⁴⁷ Pretorius, Lizl, loc.cit

⁴⁸ Broomberg, Eddie, loc.cit, p 196

⁴⁹ Broomberg, Eddie, ibid, p 196

the test for trade should not be based on the intention of the taxpayer. The following are the exact words found in this paragraph:

“Of course the intention of all concerned must be considered, but intention cannot be conclusive in the enquiry”.

Also, Lewis JA suggests that the test should be ‘whether the taxpayer was actually trading, or carrying on a business, at the time of assessment.’ Broomberg is concerned by this, as he mentions that the assessment may be raised years after the purchase and sale of the asset has been completed. Meaning, the asset may be disposed at a time when the taxpayer is not trading, or carrying a business; and have an assessment when the taxpayer has commenced trading, so would the taxpayer be liable for tax on the proceeds from the disposal of the asset? Of course not.

3.0. Conclusion

The analysis of the judgment made by Lewis JA in the *Founders Hill* case has been made throughout this dissertation with immense amount of reference to principles found in previous case laws and to the views made by various authors. The main reason for this, is because of the fact that the Act only states that the gross income should exclude capital receipts or accruals but does not does not define what capital proceeds are, also it does not give a definition of a realisation company. Thus, it is important to note that future cases on capital vs. revenue proceeds and on realisation companies will rely heavily on principles found in cases like *Founders Hill*. For this reason, it is crucial that judgments made in such cases are as accurate as possible and do not deviate from well-established tax law principles.

In my view, I feel the *Founders Hill* case should have not reached the Supreme Court of Appeal as it did, following the Commissioner’s appeal on the decision held by the Tax Court; since the Tax Court had held in favour of Founders Hill, expressing that Founders Hill had not crossed the Rubicon. As mentioned earlier, Founder Hill did acquire the property as a fixed capital asset from its parent company, AECI; however, the activities that were conducted by Heartland on Founders Hill’s behalf led to the company crossing the Rubicon, and embarking on a scheme of profit. The reason being that these activities were business-like; Heartland got on aggressive marketing for the sale of land held by Founders Hill, so as to ensure profits are

realised upon sale of the property. It is clear that the directors of Founders Hill had the profit motive and they were really passionate about making a profit on the disposal of the property, but not to merely realise the land to their best advantage.

Also, these marketing activities were done more professionally and extensively, which implies that they had the potential of becoming substitutes of other properties sold in the market since Founders Hill's property would compete with these properties on the market. It is important to note that as a result of these marketing activities Founders Hill posed a threat to property dealers in the market, as there was a chance of their properties being not purchased when clients decide to buy Founders Hill's property. It should also be borne in mind that these other property dealers are taxed at full corporate tax rate since they are trading on property and carrying on a scheme of profit making. Therefore, it would seem unfair for them to a competitor like Founders Hill who would only be taxed at capital gains tax, if any, or not taxed at all. In a word, Founders Hill deserved to be taxed since it embarked on business-like activities, which led to it crossing the Rubicon; and hence I agree with the Commissioner's line of argument.

Nevertheless, the Tax Court held otherwise and the matter went to the Supreme Court of Appeal. Despite my dissatisfaction of the decision held in the Tax Court, the main focus of the dissertation is on the judgment laid down by Lewis JA in the Supreme Court of Appeal. Lewis JA took a different view from what was believed to be the case by Founders Hill and the Commissioner. Lewis JA's view was that Founders Hill carried on a business of trade since it acquired the property with the intention of realising it, and then concluded the proceeds were revenue in nature; thus Founders Hill was liable for tax.

In my view, the reasons given by Lewis JA in her judgment for her proposition are flawed and the Commissioner should have not won the case based on the line of argument given by Lewis JA. First of all, it appears that Lewis JA did not take into account some of the important tax law principles found in prior cases. This includes principles found in the *Pick 'n Pay* case, which would have given Lewis JA an idea of what constitutes trading stock in the hands of the taxpayer. The mere intention of acquiring the asset intending to resell it in future was not decisive, but Lewis JA based her argument on this. A close look at the *Pick 'n Pay* case would have given

Lewis JA a different view, and she would have probably arrived at an opposite conclusion.

Moreover, Founders Hill was a realisation company. There are established tax law principles found in prior cases that if a parent company held an asset as a fixed capital asset and then interposes a realisation company that will dispose of the asset on its behalf; the realisation company will acquire that asset as a fixed capital asset. However, if the asset was a floating asset (trading stock) as held by the parent company, it would also be a trading stock in the hands of the realisation company. One of the leading cases on this principle was the *Berea West Estate* case, which has been discussed widely in the dissertation. It is interesting that the *Founders Hill* Court took note of this case and also relied on it to draw its conclusion on the judgment, but sadly the Court misinterpreted the principles found in the case. In addition, Lewis JA mentioned her supposed general rule and exceptions, which she believed were apparent from tax law principles found in prior cases relating to realisation companies, including the *Berea West Estate* case.

According to Lewis JA, the general rule is that a realisation company will always acquire assets from its parent company as trading stock as a result of its mere intention of reselling it. It is only in limited circumstances were the realisation company would acquire the asset in question as a fixed capital asset. I contest this general rule; with the greatest respect to Lewis JA. I strongly feel that there was no such general rule about realisation companies and Lewis JA simply deviated from the tax law principles that have been established regarding realisation companies. At our disposal, we have the *Berea West Estate* case, which gives clear principles; yet Lewis JA believes that this case was the exception to her supposed general rule. It seems unreasonable for me to believe that despite such general rule; many taxpayers, intellectuals and tax legal advisors nonetheless believed that the formation of a realisation company would ensure that proceeds are of a capital nature had the parent company held the asset in question as a fixed capital asset.

Also, as I have mentioned earlier, these special cases (limited circumstances) do not make logical sense to me and I struggle to determine the significance of these exceptional cases in making the asset in question a fixed capital asset in the hands of a realisation company. Moreover, I agree with Broomberg that the Court has no

legal power to waive the taxpayer's tax liability by a way of an exception if there is a general rule to tax a certain transaction.

In conclusion, with the greatest respect; Lewis JA missed the point in the *Founders Hill* case. The issue was whether or not Founders Hill had crossed the Rubicon, and nothing else. Although, the same conclusion that Founders Hill's proceeds were taxable would have been reached, the route taken by Lewis JA was flawed and it will likely have an impact on future cases relating to realisation companies.

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